

Draft Design for an MTC Arm's-Length Adjustment Service

**Prepared for October 7, 2014 Meeting
of the
Arm's Length Adjustment Service Advisory Group**

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Preface

This document presents a draft design for an MTC Arm's-Length Adjustment Service to support states seeking to improve equitable business tax compliance in circumstances where taxpayers are found to use transactions among related parties to undermine equity in taxation.

A few stylistic comments are in order to ease the reading of this text. First, the term "the service" and "ALAS" are used interchangeably in this design document to refer to "the Arm's-Length Adjustment Service." Second, at the close of each section or major subsections, indented questions in ***bold italics*** are raised to stimulate ideas and alternative views by the readers and ultimately discussion by the Arm's-Length Advisory Group.

This draft design is a product of listening to dozens of state tax agency staff, the members of the Arm's Length Advisory Group, MTC staff members and officials, more than a dozen private sector transfer pricing experts and veterans of transfer pricing work by state agencies beyond those that are a part of the current design effort. Almost every key fact or idea or building block in this design has its origins in those conversations. I thank wholeheartedly everyone who has visited about the design of the Arm's Length Adjustment Service for their observations, their generosity with their time and their kind consideration. It has been a great learning experience for which I am greatly appreciative.

This draft design attempts to put the pieces together into a coherent whole and to produce a suggested blueprint for a high quality project that will make a difference in improving the equity of income reporting for state corporate tax purposes. The document is merely a resource for a discussion process by the Advisory Group. The judgments of the Advisory Group will move this effort forward in the direction most suitable to meeting state needs and most feasible given their resources.

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I. Charter Period for the MTC Arm's-Length Adjustment Service

The draft design proposes a charter period for the service of four years starting with initial implementation steps in mid-year 2015. The purpose for the length of this charter period is to allow adequate time for the MTC and the states to develop, operate and evaluate the service before determining its future course.

During this charter period, all components of the services called for in the design will be implemented in phases and operated for a sufficient length of time to allow for an evaluation of the usefulness of each component. Near the close of the charter period, states will determine how the service might continue into the future.

The objective of having all components of the project operating for sufficient time to facilitate their evaluation has an important effect on the project design. It results in implementing the service in an expeditious manner and addressing all activity areas in some manner by the end of the first year—with full operations attained by the third year.

A sufficiently strong commitment by states to the project is also necessary to be able to effectively recruit talented employees and consulting economists to operate an effective service. Veteran professional staff persons are unlikely to commit to working on a project if it has a projected period of operation of only a year or two. Thus, Participating states would be asked to commit to providing funding extending throughout the charter period contingent only on the lack of availability of state appropriations for this purpose.

The states will also be asked to designate a representative and, if desired, an alternate representative to an Arm's Length Adjustment Service Committee that will advise the MTC on the operation of the service, establish operating objectives and evaluate its performance.

Questions for States

Does this initial charter period of four years seem appropriate?

Is it long enough to allow for the effective recruitment of staff and consultants?

Is it too long for the states to be asked to commit to the service (again, subject to the availability of appropriations?)

Are there other comments or suggestions with regard to the charter period?

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II. Draft Mission Statement, Goals and Objectives

- A. ***Mission Statement:*** The MTC Arm's Length Adjustment Service provides states with timely, cost-effective services and opportunities for interstate cooperation to help attain equitable compliance by corporate taxpayers with state business taxes in circumstances where improper related party transactions undermine equity in taxation.

Does this statement fully and accurately state the purpose of the service?

How could the draft statement be improved?

B. ***Goals and Objectives:***

1. Enhance the ability of participating states to correct cases of taxpayer underreporting associated with related party transactions.
 - a. Provide high-quality, cost-effective training to state staff on related party transaction and transfer pricing issues to meet standards set by the Service Committee.
 - b. Create a community of state staff working on related party issues and a forum for continuing consultation to address those issues effectively.
 - c. Provide an information exchange process to support joint work by states on related party transaction issues.
 - d. Provide economics and technical expertise on an affordable basis to evaluate taxpayer transfer pricing studies and positions and, upon request, to recommend alternative state positions on pricing.
 - e. Provide states with process improvement and case assistance services to minimize costs and maximize effectiveness of joint and individual state resources devoted to correcting taxpayer underreporting.
 - f. Provide such other services as states judge important to improving their ability to correct underreporting associated with related party transactions.

2. Increase audit coverage of related party transactions for states electing to participate in the MTC Audit Program for corporate income taxes.
 - a. Provide the MTC Joint Audit Program with training and technical assistance to enhance the program's ability to address related party transaction and transfer pricing issues.

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- b. Provide states in the program access, on the same terms as those applying to individual states, to economic expertise to evaluate taxpayer transfer pricing positions and, if requested, to recommend alternative state pricing positions in joint audits.
 - c. Provide case assistance and other services necessary to improve the ability of the MTC Audit Program to address related party and transfer pricing issues in audits.
3. Provide opportunities for satisfactory resolution of disputes involving related party transactions and transfer pricing issues.
- a. Encourage, through effective information to states and taxpayers, use of the MTC Alternative Dispute Resolution process to resolve related party and transfer pricing disputes in a voluntary and consistent manner between individual taxpayers and multiple states.
 - b. Provide states with effective support in cases that proceed to litigation to encourage well-grounded and equitable decisions in such cases.
4. Inform and advise states of emerging developments concerning related party transactions and transfer pricing issues.
- a. Monitor and conduct research on developments in the field.
 - b. Communicate developments and their implications to states in a clear, useful and timely manner.
 - c. Provide appropriate advice to states on such developments.

Do these goals and objectives, in general, reflect the views and expectations of the states for the projected arm's length adjustment service?

Are there any important goals or objectives that should be added to the above?

Should any of these be deleted?

What amendments should be made to particular goals or objectives?

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III. Strategies Recommended to Improve Efficiency and Effectiveness

This service design incorporates certain strategies recommended to improve the efficiency and effectiveness of the proposed service. They are described here so the advisory group can evaluate them and provide alternative guidance if necessary.

Getting First Things First or Timing Is Everything: States are eager to gain access to joint economics expertise to help deal with complex transfer pricing issues. Securing that expertise requires putting in place first a core framework for making this endeavor a success. Those who will manage the contracts with outside firms and coordinate the work with the states need to be hired. The states and staff working together need to establish contracting and information exchange processes. Goals, performance objectives and administrative parameters need to be set to guide both short-term expectations and long-term accountability. Pre-service implementation work and a timetable will be needed to enable the employment of a core service staff within the early weeks of its launch so that an expeditious contracting process can follow.

Interdisciplinary Collaboration: Success in dealing with related party and transfer pricing issues requires a collaborative approach among persons with different professional backgrounds: tax compliance/auditing, economics and the law. Transfer pricing issues involve a large quantity of complicated details that require work and evaluation from different perspectives and professional expertise. Integrating the different types of expertise is one key to effectively identifying and resolving those issues. Failing to do so can waste time, money and energy and can diminish the results achieved. The projected MTC service staff would be expected to effectively combine that expertise in their own work and provide training and advice to states from that perspective. Thus, the service would support states in using interdisciplinary approaches in addressing transfer pricing issues.

Improving Compliance Processes to Achieve Results: A third strategy involves evaluating the compliance process from beginning to end to develop procedures and steps likely to achieve the most productive compliance results. The design seeks to identify key points where the proposed services can make the most effective contributions to the state efforts aimed at improving compliance. Often those points are earlier rather than later in the compliance process because it is more costly and difficult to make up for lost opportunities in the later stages of a case.

Efficient use of resources: A fourth strategy involves a determined focus on using scarce and expensive resources wisely and efficiently. Often that means ensuring the expensive economics expertise is not used on technical tasks that can be performed using other resources. It also means that information needed for economic analysis should be sufficiently acquired at an early stage so that the economists can work with the most relevant information in arriving at their conclusions. Applying

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expensive analysis to inadequate information typically does not yield the most effective results.

Capacity Building: A final strategy involves maximizing opportunities to expand the capacity of the states and the MTC to address related party transfer pricing issues. The purpose is to reduce costs and maximize results over the long term. There are several parts to this strategy. One part involves an emphasis from the outset on training and mutual assistance for the states. Another part involves providing continuing opportunities for state staff at different levels to share their knowledge and experience with each other. A central idea is to develop a growing community of state staff well versed in related party and transfer pricing compliance issues who work together across state boundaries to solve compliance problems. A third part involves not simply "renting" economics expertise from outside firms, but asking those firms to develop that expertise within the MTC staff. Aiming to strengthen the capacity of the states may be the most important and enduring effort the service can pursue.

Are these strategies and their relationship to ALAS activities clear and understandable?

Do they make sense?

Is there agreement that these are valuable strategies or is any aspect of the ideas unnecessary, irrelevant or even detrimental?

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IV. Elements of the Arm's Length Adjustment Service

A. Training

Training of state staff will likely be a critical component of the service and would be provided through formal courses, conference meetings of state staff and individual mentoring or coaching. Much of the mentoring will occur through the "case assistance" component of the service, which is described later in this design.

The Arm's Length Adjustment Service Committee should set standards for the types and levels of knowledge to be attained through ALAS training.

Formal course training would be offered in two broad topic areas:

1. Federal and state tax laws and regulations that apply to related party transactions, and
2. Methods of achieving equitable compliance when related party transactions undermine proper income reporting.

The audience for the training will be state and MTC staff involved in related party and transfer pricing issues including managers, auditors, attorneys and policy staff.

The faculty for the courses will include the core ALAS staff with expertise in law, economics, tax auditing and administration. The staff would be supplemented with experts from states and consulting firms as needed.

The service will also explore opportunities to work with the IRS on training. Those possibilities are not known at this point.

The training in the substance of state and federal laws and regulations is self-explanatory. Training in compliance methods deserves some additional discussion. A wide range of topics may fall within the compliance methods category and will likely include:

- Audit selection procedures,
- Planning audits of related party transactions,
- Identifying transfer pricing problems,
- Understanding how to integrate economic analysis into the audit process,
- Using and enforcing effective information document requests,
- Conducting technical audits of transfer pricing studies prior to economic analyses,
- Developing defensible transfer pricing adjustments, and

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- Other compliance techniques and approaches.

One or more of these compliance methods topics may be the subject of their own specialized training courses. Near the end of year one or early in year two, the service would provide a separate course to train state staff on technical audits of transfer pricing studies prior to economic analyses. Training of this type is a priority because technical audits can improve the quality of the subsequent economic analyses, prevent the expenditure of time by economists on non-economic analysis and even provide a separate factual basis for state audit adjustments.

While it may or may not be offered in a special course, the service may also give priority to training on securing appropriate information to support effective transfer pricing analysis. Making certain that adequate supporting information is secured along with taxpayer transfer pricing studies is a critical step in ensuring that economists can do an effective job of analyzing those studies. Topics may include tax return design, audit protocols, information document requests and enforcement of such requests. This topic is discussed further in related sections of this document.

Beyond formal courses, the service will also provide training through regular interstate staff conferences. Some case discussions (during confidential sessions) will be inherent in the Service Committee meetings that typically involve management level personnel. More significant for training purposes would be regular sessions of front line state staff—lead auditors, audit supervisors and attorneys—that would be scheduled periodically to review case histories and compliance procedures.¹ These conferences will be useful as both a general vehicle for training, but will also serve as means of spreading knowledge among states concerning emerging issues. The conferences might occur twice a year and include special presentations on a rotating basis by individual states and also by outside experts. Breakout sessions for attorneys on litigation in process could also occur at these conferences.

Developing the training component of the Arm's Length Adjustment Service will be an early priority for the work of the initial staff members employed for the service. This initial staff employed in the first few months would include (1) a tax manager with expertise in audit processes, (2) an attorney with related party transaction expertise, and (3) a senior economist with substantial transfer pricing experience. Among other work, this staff would be charged with developing the core courses on related party laws, practices

¹ Thanks and credit goes to the District of Columbia for highlighting the need for the service to engage front-line compliance staff, to provide training tailored to their needs and to create an interstate community of transfer pricing compliance experts.

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and compliance methods drawing on their respective disciplines. The staff would also initiate early the first interstate consultation session for frontline staff.

Within about six months, the service would also employ a “transfer pricing study auditor” to conduct those audits and also to develop training for state staff to conduct similar audits on a coordinated basis. The objective would be to develop a network comprised of the MTC pricing study auditor and study auditors in individual states to ensure that each taxpayer transfer pricing study would undergo a technical audit prior to being submitted for an economic analysis. Individual states may also rely on technical analysis as a basis for audit adjustments in cases where an economics analysis is not performed.

Overall, the training component of the service will contribute to the development of a community of MTC and state experts who will be able to work together to address related party transaction issues on a continuing basis.

Training course costs would be financed through a combination of variable course fees for ALAS member and non-member states and the ALAS fee paid by member states. States that are members of ALAS would pay per student course fees that cover outside faculty (faculty who are not ALAS staff members), site costs, materials, faculty travel and other incidental costs. States not participating in ALAS would be welcome to participate on a space available basis. The course fees for non-members would include the costs paid by ALAS members plus the preparation and instructional time of ALAS staff serving as faculty. The ALAS states would not be paying a course fee that includes the cost of ALAS staff serving as faculty because training is a core mission of the service and their fee already covers that cost.

The cost of training at interstate front-line staff conferences and the ALAS Committee meeting would be funded by the ALAS fee.

Does the proposed training focus on the right priorities?

Do you have any comments on any aspects of the training description?

Is the effort to create a community of front-line staff who share their knowledge and work together a reasonable priority to pursue?

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B. Transfer Pricing Analysis

The primary impetus for the Arm's Length Adjustment Service has been the identified need of states to find a cost-effective means of evaluating taxpayer transfer pricing studies. Through the service, states will be able to secure analyses of taxpayer transfer pricing studies and independent recommendations for alternative transfer pricing remedies.

Economics expertise for transfer pricing purposes is expensive. Thus, this service design incorporates three strategies to minimize those costs or maximize the quality of the work performed. One strategy involves ensuring that the taxpayer information, secured during state auditing the taxpayer, is sufficiently complete to support a quality analysis. The second strategy involves conducting technical, non-economic audits of audits prior to the economics analysis. That prevents the time of economists from being spent on non-economic analysis and enables economists to account of technical flaws in transfer pricing studies in doing their work. The third strategy consists of developing MTC staff to conduct the economic analysis at costs lower than those incurred through contracted services.

The first strategy to maximize the value of expensive consulting services is to assist states in securing information from taxpayers that helps ensure that the consulting economists can conduct the best possible analyses of the transfer pricing studies. Economists need access to adequate background materials used to produce the taxpayer's transfer pricing studies if they are to produce an effective evaluation of those studies. Accordingly, this design proposes that the service help states in securing the necessary information for analysis through the training, process improvement and case assistance. Details of this strategy are discussed in those portions of this design.

The purpose of the second strategy—conducting initial technical audits—would be to identify calculation errors, inconsistencies and flaws in the selection of comparable prices or profits and other technical problems of a non-economic nature. The design recommends that the technical audits be performed by a transfer pricing study auditor who would develop and work with, as explained in the training section, a network of state staff devoted to the same purpose.² The technical audits would be divided between the MTC study auditor and designated state staff, with state staff working on a portion

² If the states do not find feasible or advisable conducting technical audits of transfer pricing studies through a combination of MTC and state staff, the options are to conduct them entirely through one of those means or the other. The MTC staff could be expanded to conduct all of the technical audits. Alternatively, the states could take full responsibility for those reviews. In the latter case, there would still need to be some coordination by the MTC to ensure full coverage and to link the work on the technical audits with the corresponding economic analysis of the transfer pricing studies.

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of the transfer pricing studies in which their state is a participant. By conducting technical audits up front, the states should receive higher quality and more cost-effective evaluations of taxpayer transfer pricing studies.

Turning to the third strategy, at the outset of the service contractors would provide nearly all of the economics expertise for transfer pricing studies and alternative pricing positions. However, over the first four years of the service, this design proposes that an MTC economics staff would provide a progressively increasing portion of those services. Shifting transfer pricing analysis substantially, but not entirely, from contractors to MTC staff will reduce the costs of the analysis significantly and brings this capacity into a joint agency governed by the states. It also integrates the analysis of transfer pricing studies more closely with the other components of the service.

The design assumes that through the initial senior economist and the addition of two additional economists (one each in the second and third years of the service), MTC economists would perform about 70% of the economic analyses of transfer pricing studies for the states by the fourth year of the service's operation. Staff would provide the regular and standard transfer pricing analyses and contractors would handle more specialized issues or cases that could not be accommodated within the MTC staff workload. At the conclusion of the charter period for the service, states can evaluate this division of work between contractors and MTC staff and decide whether to continue that division into the future or change it further.

Beyond the analyses of the taxpayer studies, the economics expertise—whether through contractors or staff—would also produce alternative pricing recommendations to the extent desired by states.

Within the framework described above, there are some questions that need to be addressed concerning the organization and management of the economics consulting services. The questions include the following:

- Should the contract be entered into between the consulting firm and the MTC or the consulting firm and the multiple states within the service?
- How should the services be coordinated?
- On what basis should the consulting firms be paid and how should the financial arrangements be managed?
- If the MTC economic analysis staff is not developed as suggested above, should the service engage the services of more than one consulting firm?

The first two questions regarding the contracting arrangements and coordination are intertwined with each other. The practical need for timely

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and effective coordination of the various elements of the service on behalf of all participating states would appear to require that the contract be entered into between the consulting firm(s) and the MTC. It is difficult to see how the necessary coordination would occur if the contract were written between the firm(s) and the several states. Meshing the contract, managerial and fiscal requirements of each state would also appear to be a major and difficult task. An MTC contracting arrangement also provides a consistent, coordinated point of accountability for evaluating the performance of a contractor. Thus, this design assumes the MTC would be the contracting party with the firm(s).

In practice, coordination between the transfer pricing contractor's work, the in-house economists and the states would be the responsibility of the senior economist on staff. The senior economist would assign work to either the contractors or the in-house staff and, in both instances, evaluate the quality of the work performed. The senior economist and the study auditor would also coordinate the flow of technical audit results to the economists performing analyses of the same studies. The staff attorney would of course, handle legal contracting issues.

The MTC contracting arrangement carries with it certain implications for the financing of these services. The audit provisions of the Multistate Tax Compact include a requirement that services be reimbursed on a cost basis. In practice, that provision has been interpreted as requiring the Commission, in its compliance work, to avoid reimbursements tied to audit results. In this instance, a transfer pricing study is, in fact, an audit service. Thus, an MTC contract would seem to require that a consulting firm be reimbursed on a cost basis and not on any contingency fee or performance basis. A cost basis would mostly likely translate into payments per hour or per study.

In practice, sharing the pricing analysis costs among states on a basis proportionate to costs incurred may translate into the following budget process. Each year the budget for transfer pricing studies would be prepared based on an anticipated average usage of the study service. That would translate into an estimated budget that would cover the anticipated costs of consulting economists, ALAS economists and the study auditor. That budget would be divided among the states equally, and the resulting amount would be considered the base charge to states for transfer pricing analysis. It is important to note that the "transfer pricing analysis charge" is one part of the total fee that states would pay for the service.³

³ Please see Section G starting on page 22 for a discussion of the overall fee structure for the service. The other parts of the fee would be a "general services charge" for all the other components of ALAS (training, process improvement, information exchange, case resolution and litigation support) and an administrative surcharge for states that are neither Compact nor Sovereignty members.

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If actual usage, and hence, costs exceed the original estimated amount, then additional charges over and above the base charge would need to be assessed to those states using the analysis service at a higher than average rate. The additional charges would allocate costs so that final state payments for transfer pricing analysis would be proportionate to each state's usage of the analytical services.

ALAS members and the MTC need to decide if states that do not use their entire base charge for transfer pricing services receive a refund (or alternatively a credit for studies in future years), or whether the unused balance of the base charge is retained as a reserve to the service to cover unanticipated costs or other contingencies.⁴ If the refund or credit system is used, the states may need to agree on extra payments beyond the base fee in early years of the service to build up a financial reserve for the service.

This budget process for transfer pricing studies analysis would work in the same manner whether the audits in which the studies have arisen are being performed by individual states or through the MTC Joint Audit Program. In the case of state participating in both ALAS and the Joint Audit Program, the state would have paid for its share of the transfer pricing analysis through the base charge or an additional fee for "above average" usage of the study analysis service. States in the Joint Audit Program that not members of ALAS but wish to address transfer pricing issues in audits would be asked to pay the base ALAS transfer pricing study fee and additional fees for any "above average" usage of the study analysis service.

Another fee issue to be considered is how to deal with instances where only some states initially participate in analyzing a case, but other states subsequently use the analysis after it is completed. Would the states using the analysis later pay a share of the costs of that analysis? Would the funds from the "late cost-sharing" go into a fund to finance credits to be used by the initial states to help finance future analyses or other fees? Or would the late payments go to reserve funds for ALAS?

Turning now to the last question involving the possibility of contracting with more than one consulting firm, it is likely relevant only if the service does not develop the level of in-house MTC economics staff described earlier. If that staff is not developed, states should consider engaging two consulting firms instead of one. The primary reason for doing so is that a firm may encounter

⁴ There are different circumstances that could cause a state to not use its entire base fee. One circumstance is where the state participates in fewer study analyses than the base fee would allow. Another is where the state participates in an average or even greater number of analyses, but the number of states participating in each analysis was higher than the average number predicted, thus reducing the actual per state cost of the analyses. A third circumstance might be instances where the analyses were lower in cost than originally anticipated.

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a conflict of interest in helping states if that firm has a prior or current relationship with a taxpayer under audit by states.⁵ In that case, an alternative provider would be available. A second reason is that different firms may offer different capabilities and types of services to states. Having two firms involved increases the diversity of expertise to the states. A third reason is to ensure the availability of services if one of the firms does not have the capacity to handle the total work needed by the states at any given point in time.

One possible downside of engaging two firms is that the volume of work would be divided in some manner between the two, lessening the priority that both firms might give to the service and the needs of the states. Another possible downside might occur if the two firms use methodologies that do not mesh well with each other. The selection process for two firms would need to take into account the avoidance of inconsistencies in the approaches of the separate firms.

Do the three strategies for maximizing the cost-effectiveness of expenditures for economic analysis of transfer pricing studies make sense?

Do you concur with the reasoning underlying an MTC contractual arrangement with consulting firms?

What are your thoughts on the managerial and financial issues raised in the latter portion of this section?

⁵ Thanks and credit goes to the Florida Department of Revenue for noting the potential for conflicts of interest to arise and the possible need for more than one contractor to deal with the issue.

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C. Process Improvement, Information Exchange and Case Assistance

This section covers elements of ALAS that will provide support exclusively to participating states in improving their effectiveness in addressing related party transactions that undermine equitable corporate tax compliance. As in the case of training, these activities are not limited to cases selected for transfer pricing analysis. They would apply to any issues or cases encountered by ALAS states involving related party transactions and transfer pricing.

The tax manager, senior economist and attorney working together and integrating their knowledge and expertise with each other would undertake the activities described in this section. The process improvement and case assistance will carry forward some of the key strategies described early in this design: encouraging joint work by professionals from different disciplines, improving compliance processes to achieve effective results, and using scarce resources efficiently.

"Process Improvement" activities include those efforts referred to in prior service design documents as "information management," plus additional activities. The efforts will include assisting states with improved practices and procedures for securing taxpayer information through tax returns and other forms by adding questions and items concerning related party transactions. The service will also help states develop audit protocols, possible documentation regulations and standard information document requests that make clear to taxpayers the information required in audits to address related party and transfer pricing issues.

Beyond information management, this element of ALAS will assist states with audit selection procedures and methods for identifying related party issues in audits. The service will also cover legal process issues increasingly raised by taxpayers. Given the complexity of adjusting related party transactions, extra care is needed to avoid errors of process, protect taxpayer rights and meet constitutional requirements in carrying out compliance responsibilities to the public.

In general, the ALAS staff will be prepared to assist individual states in reviewing their practices and procedures regarding related party transactions to help ensure that tax agencies are able to do their best in meeting their responsibilities to the public of ensuring equitable compliance with the law. This assistance would be available on request by individual states.

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"Information Exchange" will include developing a memorandum of understanding for a confidential taxpayer information exchange process through designated disclosure staff. Initially, the exchange process will ensure that states can notify each other when they encounter cases where they believe a joint economic analysis of a taxpayer's transfer pricing study is warranted. If there is sufficient state interest, service staff will convene discussions among the states to organize the technical and economic reviews of the pricing study. The exchange will also be the vehicle for sharing the actual study information and related documentation as well as the results of any joint analysis.

As the exchange process matures, states may choose to exchange other information concerning related party transactions. The nature and extent of those efforts will depend on state initiatives in this area.

"Case Assistance" will involve the ALAS staff in providing advice to individual states concerning procedures and issues in particular taxpayer cases. The advice would be provided at the request of the states. For example, a state might seek advice on how to tailor an information document request to a complex taxpayer case. Or the state may be interested in an evaluation of legal issues inherent in a case. Or the state may seek help with interpreting the statistical analysis of the taxpayer's transfer pricing study. There could be hundreds of types of questions on which states might seek help. The service would seek to have available the combination of legal, economic and tax expertise necessary to respond effectively to a wide range of state requests for assistance.

Much of the thrust of the case assistance work will be to advise and coach states on steps taken early in an audit to ensure that opportunities are not missed to secure necessary information and evaluate issues so that the case can be brought to its most appropriate and equitable conclusion. Another emphasis will be methods of linking together the expertise and perspectives of auditors, economists and attorneys working on cases.

ALAS staff would provide the same type of assistance as needed to the MTC audit program as it conducts audits for participating states that involve related party transactions.

Are the explanations of these "capacity strengthening" elements of the service logical and understandable?

Is the rationale for process improvement work and its linkage to improved transfer pricing analysis and better case results clear?

Do you have any comments or conclusions regarding these proposed elements of the service?

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D. Case Resolution and Litigation Support Services

The service would offer a taxpayer and multiple states the opportunity to use the MTC Alternative Dispute Resolution (ADR) program to resolve disputes over related party transaction assessments at one time. On an informal basis, case resolution between a taxpayer and multiple states also occurs within the Joint Audit Program process.

The MTC ADR process has its own well-established procedures and mechanism for sharing the cost of dispute resolution. It is ideally suited for use by ALAS and appears to require no modification for this purpose.

In cases that go forward into tax appeals and court processes, ALAS staff would be available to provide legal advice and support to states in related party transaction cases. It could assist states in evaluating the positions taken by the parties in a case and advise on possible courses of action. It would arrange for expert witnesses from the economists—contractors or MTC staff—that evaluated transfer pricing issues in a case. While reimbursement of contractor's time serving as an expert witness would likely be necessary, that would not be the case with regard to MTC staff.

In the future, the ALAS states and staff could also explore the feasibility and desirability of developing and using an advance pricing agreement process with taxpayers.

Do you any comments or suggestions on case resolution and litigation support services?

E. Optional Joint Audits

ALAS states seeking to expand audit coverage of related party and transfer pricing issues would be invited to join the corporate tax portion of the MTC Joint Audit Program. The objective would for the audit program to provide joint audits with the same training, transfer pricing analysis and case assistance available for individual states audits. The costs of transfer pricing analysis for ALAS states in joint audits would be financed through the portion of the ALAS fees for that purpose. Non-ALAS states in the Joint Audit Program interested in addressing these same issues in audits would be asked to pay the same fees for transfer pricing analysis as the ALAS states.

As ALAS becomes operational, the MTC Joint Audit Program would begin to develop the ability to address transfer pricing and other related party issues as the states themselves address them. Initially, audit cases involving such issues would arise out of audits that were not selected for that purpose. Over time, the Audit Committee will consider a number of issues concerning

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transfer pricing audits. Those issues will involve matters such as coordinating the timing of work on transfer pricing issues with other issues in the joint audits and the role that transfer pricing criteria might play in future audit selection. These issues are not unusual for the Audit Committee. It has addressed similar questions and adapted the Joint Audit Program to meet the changing audit needs of the states on a continuous basis over several decades.

Does this section reflect the consensus arrived at by the Advisory Group?

Is this explanation sufficient, or is further detail needed?

F. Service Timeline, Staffing and Budget Considerations

Timeline: This design proposes a timeline for the service that begins even prior to its formal launching with early distribution of information about the potential recruitment of initial staff positions and formal circulation of job announcements once the MTC Executive Director determines that sufficient funding commitments are available.⁶ This process would hopefully lead to the hiring of three core positions within the first two months of the service: a tax manager, senior economist and attorney.

That staff would initiate, in consultation with the ALAS Committee, a contracting process for economics consultants, the organization of early training efforts and the completion of the information exchange memorandum of understanding. The information exchange process would be activated in time for the first transfer pricing study selections.

In the middle of year one, the service would employ the “pricing study auditor” to begin technical audits of the selected transfer pricing studies. The pricing study auditor would also commence training of designated staff persons from states who would also assist with the technical audits. Because of the initial organizational and training steps, technical audits may not be completed for all the selected transfer pricing studies. Some may need to proceed to economic analysis without the benefit of thorough technical audits. All but one of these studies would be referred to consulting economists for analysis. The MTC senior economist would complete one of the studies by the end of the year.

⁶ Other draft documents could be prepared prior to the launching of the service to accelerate its operations. Besides job announcements, they could include position descriptions, draft interview questions and rating materials. For other parts of the service, documents and drafts relevant to the subsequent completion of an exchange of information agreement and RFP process for consulting economists could be compiled or developed to jump start the work on the staff attorney employed in the early weeks of the service.

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By the end of the first year, the staff would also organize the elements of the service involving training, process improvement, case assistance, case resolution and litigation support and begin providing services through them as requested by the states. The service would have convened at least one of interstate consultation sessions for front-line state staff persons who work on related party transaction issues. It would also have conducted at least one formal training course.

The number of economic analyses of pricing studies would be dependent on how much funding states are able to provide for that activity. A potential target for economic analysis by the end of the year might be 9 studies, 8 by consulting economists and 1 by the MTC senior economist. Assuming three states participate on average in each study analysis, 9 studies translate into 27 state reports. Please note that these numbers and similar numbers below are only targets and are not a certainty.

Also at the end of its first year, the service would employ an additional economist to expand its capacity to undertake economic analysis of pricing studies. The senior economist would provide training to the new economics staff member.

By the end of the first year the ALAS Committee should be well established in its operations. The committee will provide ongoing advice and guidance to the staff. The committee should also have defined by this point the performance measures by which it will evaluate the service through the remainder of the charter period.

In the second year, all of the ALAS elements would be active, and a full complement of training courses should be underway. Likewise, process improvement and case assistance services should reach a regular and high level of activity.

In terms of technical and economic analysis of transfer pricing studies, the target completions for the second year—depending on funding levels approved by states—might be about 18 studies, 5 by MTC staff economists and 13 by consulting economists. The 18 studies would translate into 54 state reports.

At the end of its second year, the service would employ an additional staff economist to again expand the in-house capacity for economic analysis of pricing studies.

In the third year, ALAS should be in regular and routine operation. The ALAS Committee should be providing feedback to the staff and the states on

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progress in meeting performance objectives. In this year, the service might well evaluate the scope and methods for information exchange activities and consider its expansion.

Again dependent on the level of funding for this purpose, the target level of economic analysis of pricing studies in the third year might be about 24 studies, 14 studies by MTC staff economists and 10 by consulting economists. If not attained in the prior year 100% of the studies should have undergone technical audits prior to economic analysis. The 24 studies would, assuming 3 states per study, translate into 72 state reports.

No changes in the number of staff would occur at the end of the third year.

In the fourth year, again depending on funding, the target analyses might be 27 studies, 19 by MTC staff and 8 by consulting economists. Full technical audit coverage should occur. The 27 studies would, assuming 3 states per study, translate into 81 state reports.

In the third and fourth years, case resolution and litigation support activities is assumed to have increased and reached a parity with training, process improvement and case assistance efforts.

The ALAS Committee should in this final year of the charter period complete its evaluation of all service components. A consultation process would be undertaken among tax commissioners of participating states, the ALAS Committee, the MTC Executive Director and Executive Committee concerning the renewal of the ALAS charter and modifications in the extent, nature and direction of any of the ALAS activities.

Staffing: This section of the design will summarize the responsibilities and nature of ALAS staff positions.

The core ALAS staff would consist of a tax manager with expertise in audit processes, an attorney with related party and transfer pricing expertise, and a senior economist with transfer pricing experience. Other staff would include a pricing study auditor to conduct non-economic audits of transfer pricing studies and to train and coordinate with state staff devoted to similar non-economic audits of such studies. At the beginning of years two and three, the design proposes the addition of one transfer pricing economist in each year to expand the in-house staff devoted to transfer pricing analysis.

The tax manager will be responsible for key, regular communication between state staff and the service, including major requests for assistance and the selection of transfer pricing studies for analysis. The tax manager will coordinate with other ALAS staff the responses to the request for assistance.

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The manager will assist in staffing the ALAS Committee and be the primary organizer of the semi-annual interstate consultation sessions among front-line state staff. The manager will have lead responsibility for coordinating the information exchange, training and case assistance services. This position may also supervise the pricing study auditor (or the senior economist may do so). The tax manager will bring audit expertise to the process improvement activities, will serve as faculty for audit topics in training courses and will provide case assistance on audit methods to state staff.

The attorney will provide legal support for the administration of the service, including the information exchange and contracting processes. The attorney will serve as faculty on legal matters for training courses and provide advice on the law to states in case assistance activities. The attorney will provide leadership for the service's case resolution activities and provide litigation support to states in disputed cases. The attorney will participate in process improvement efforts with the states, focusing on ensuring that legal process standards are attained.

The senior economist will supervise the service's economic analysis of transfer pricing studies. The senior economist will play a lead role in selecting, supervising and evaluating both consulting economists and staff economists. This position will also conduct some analyses of pricing studies and review and approve the analyses performed by other ALAS economists. The position will coordinate with the tax manager and technical pricing auditor on pricing studies in process. This position will serve as faculty on economics subjects in training courses and an advisor to states on economic analysis and its effective use in audit cases. In process improvement activities, this position will focus on how to best develop information in a case to ensure quality economic analysis. The position would provide economics expertise in case resolution efforts and serve as an expert witness in litigation.

The pricing study auditor will conduct technical audits of taxpayer transfer pricing studies prior to economic analysis. The auditor will also organize and train a network of state staff persons who will undertake the same type of efforts to ensure coverage of all pricing studies.

The two staff economists—the first hired at the end of year one and the second by the end of year two—will conduct economic analyses of taxpayer transfer pricing studies. As available and appropriate, they will also assist with training, case assistance, process improvement and case resolution work. As they gain experience and expertise, the economists may also serve as expert witnesses in litigation.

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Budget Considerations: As noted on page 1 in the section concerning the charter period, one important factor affecting the budget is the design objective of having all of the components of the project operating for a sufficient time in the first four years to enable the states to evaluate their effectiveness. That objective helps drive the expeditious development of the project and adds impetus to filling the three key service positions in the early months so that the organizational and intellectual framework necessary for success is in place from the outset.

The largest single component and the majority of estimated costs in the charter period will likely be expenditures for transfer pricing analysis. Contract expenditures for consulting economists will be concentrated in the first three years of the service. In the fourth year, there may be a rough parity between the budget amounts for in-house economic analysis and consulting firm analysis. However, the in-house analysis at that point will account for a about 70% of the analytical output because of lower costs per study.

The training, process improvement, information exchange, case assistance, resolution and litigation support—much of which is designed to improve the quality and effectiveness of the transfer pricing analysis work—will comprise a minority of the project costs in the first four years.

As in-house transfer pricing analysis replaces the work of consulting economists, the average costs of an individual state analytical report will fall. At the levels of activity projected above and some assumptions about costs, the average cost of a state report would likely decline from about \$25,000 per report in year two to about \$15,000 in year four. The target number of reports would also be rising substantially from about 54 in year two to about 81 in year four.

One means for trimming budget costs would be to reduce the number of analyses of pricing studies conducted in years two and three, by reducing the expenditures for consulting economists. While the number of analyses would be fewer in those two years, the number analyzed in year four might remain the same as initially projected due to the expanded in-house capacity to conduct that work.

A second cost-cutting strategy would be to eliminate the technical audits of taxpayer transfer pricing studies. That, however, would likely have a detrimental impact on the cost-effectiveness of economic analysis by devoting economists' time to non-economic issues and decreasing the quality of analysis due to non-economic issues that may be neglected. Without technical audits to improve the quality of data for the economic analysis, there is a substantial risk of encountering the familiar "garbage in, garbage out" problem for the analytical work.

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Postponing employment of the core ALAS staff in the early months does not seem advisable. Without the core staff of a tax manager, attorney and senior economist, the basic infrastructure for the entire service will not be in place on a timely basis. The risk of administrative and legal error in information exchange and contracting processes would be increased substantially. There would be also be a risk of inadequate communications between ALAS and state staff and officials, reducing the quality of work and creating frustrations and potential service difficulties. The quality of training and case assistance would be lessened.

Delaying core staff would also dim substantially the prospects for effective process improvement and litigation support work. The process improvement work is especially important to ensuring that states secure adequate supporting information early in an audit so that economists have that information available to perform quality analyses. Further, without a senior economist on board early, the prospect for cost saving by moving transfer analysis in-house would be deferred to some point in the future if not indefinitely. Likewise, the idea of building a strong interstate community of front line staff who work on related party transaction issues may be postponed or even unfulfilled.

For these reasons, the strategy of reducing the number of contracted transfer pricing analyses in the second and third years appears to be the approach that might well be given first consideration if any cost-cutting is needed.

Is the explanation of the timeline clear?

Do the pieces of the timeline fit together in a logical and potentially effective manner?

Do you have any suggestions for the timeline?

Do the roles of the ALAS staff seem appropriate, well-conceived and sufficient? Are there any gaps or deficiencies in the summary descriptions of the positions?

What is your assessment of the issues addressed under the budget considerations?

G. Potential ALAS Fee Structure

As noted above, part of the fee structure for the service might be calculated on a cost basis for transfer pricing analysis services. A "base charge" for services would be paid at the beginning of the year, with adjustments made

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near the end of year for differential usage by states of the analytical services. This would cover the cost of consulting economists, MTC staff economists and the study auditor. The statutory touchstone for the cost approach to allocating these costs is Article VIII of the Multistate Tax Compact on interstate audits. It requires reimbursement to the Commission for specific audit services on a cost basis. A transfer pricing analysis is a service that is a component of a specific audit. Thus, this design assumes that basis is the appropriate starting point for discussion of the allocation among states of these analytical services.

That leads to consideration of the fee structure for the elements of the service aimed at strengthening the capacity of states to address related party transactions and transfer pricing issues. These elements include training (to the extent not covered by course fees), process improvement, information exchange, case assistance, case resolution and litigation support. These services are generally analogous to the general services that the MTC provides to its Compact and Sovereignty members. Again, the Multistate Tax Compact provides a possible basis for allocating these costs among states.

The Compact provides that general services be financed by a formula consisting of 10% on equal shares and 90% on relative revenues. The assumption appears to be that the relative value or benefit received from services strengthening the capacity of states is a primarily a function of the size of a state. Hence, this design suggests the general services formula of the Compact as the starting point for allocating the cost of the capacity building work of the ALAS. In this case, the relevant revenues to consider would be corporate income or business tax collections.

Beyond these fees, MTC policy requires that states that are not Compact or Sovereignty Members pay a 20% administrative surcharge on the direct fees. Further as referred to at various points in this design, training course fees are also charged, but are less for ALAS members than for non-member states due to the exclusion of ALAS staff member faculty costs from the course fees for ALAS members. States joining the MTC Joint Audit Program will incur the regular costs for that purpose. Finally, participation in an alternative dispute resolution process will likely require payment of a share of the costs of a mediator.

Does the analysis based on the MTC Compact provisions for both fee categories make sense?

Are there other approaches that should be considered?

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V. Measuring ALAS Performance

The draft mission statement, goals and objectives in Section II above are a first step in establishing a well-understood, common focus for the service, its participating states, MTC management, ALAS staff and contractors. Refining and ultimately ratifying those statements through the Advisory Group and future ALAS Committee are vital steps in establishing a management framework for the service. The framework provided by the mission statement, goals and objectives can and should be used to establish measurable performance objectives and benchmarks so that states and the MTC can effectively and fairly evaluate the work of this service.

As this design is refined and completed, the Advisory Group could focus on developing a draft of those performance measures to help accelerate the work of the ALAS Committee and staff once the service is launched. This design recommends that work as a key next step in this development effort.

Is this an important and logical next step?

